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District Court Upholds Future Claimants' Due Process Rights Against Broad Releases in Section 363 Sale Order

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The United States District Court for the Southern District of New York recently held that a bankruptcy court sale order issued under Section 363 of the Bankruptcy Code could not extinguish state law successor liability personal injury claims brought against the purchaser by third parties injured after the close of the bankruptcy case, but whose injuries arose out of conduct of the debtor prior to its bankruptcy. The authors of this article discuss the decision and its important practical implications for purchasers of assets from a debtor's estate.

The United States District Court for the Southern District of New York on March 29, 2012 held that a bankruptcy court sale order issued under Section 363 of the Bankruptcy Code ("Section 363") could not extinguish state law successor liability personal injury claims brought against the purchaser by third parties injured after the close of the bank-

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ruptcy case, but whose injuries arose out of conduct of the debtor prior to its bankruptcy.[1] Although the Second Circuit Court of Appeals has not yet considered this issue, the district court's decision is in line with those of other circuit courts that have ruled on similar issues.[2] This decision has important practical implications for purchasers of assets from a debtor's estate.

FACTS

Grumman Olson Industries, Inc. ("Grumman"), a manufacturer of products used in truck bodies, filed for Chapter 11 protection in late 2002.[3] In July 2003, a predecessor of Morgan Olson LLC ("Morgan") purchased certain of Grumman's assets in a Section 363 sale. The bankruptcy court order approving the sale (the "Sale Order") provided that the sale would be "free and clear of all…claims…and all debts arising in any way in connection with any acts of [Grumman]" and that Morgan would not be subject to "any liability for claims against [Grumman]…including, but not limited to, claims for successor or vicarious liability …."[4] Almost three years after the close of Grumman's bankruptcy case, Ms. Frederico ("Frederico") was injured when the truck she was driving, which included products manufactured by Grumman prior to the bankruptcy case, struck a telephone pole. Frederico filed a complaint against Morgan for Grumman's allegedly defective products under New Jersey's successor liability law (the "New Jersey Action").[5] Morgan then filed an adversary proceeding in the bankruptcy court, seeking, among other things, to bar Frederico from pursuing the New Jersey Action.[6]

APPLICABLE LAW

Although a purchaser of assets is not generally liable under traditional common law for the seller's liabilities, courts have crafted certain specific exceptions. One exception is New Jersey's "product line exception," under which a purchaser may be subject to successor liability if it purchases a "substantial part of [a] manufacturer's assets and continu[es] to market goods under the same product line."[7] The New Jersey Supreme Court has held that the product line exception survives even when the assets are

transferred pursuant to a sale order in a bankruptcy case.[8] In the New Jersey Action, Frederico argued that Morgan is subject to successor liability under the product line exception.[9]

Section 363 of the Bankruptcy Code authorizes the sale of a debtor's assets "free and clear of any interest in such property of any entity other than the estate."[10] Courts in the Second Circuit have interpreted Section 363 to allow the sale "free and clear" of any interests as well as all "claims."[11] The Bankruptcy Code broadly defines "claim" to include any "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured."[12]

THE DISTRICT COURT

Affirming the bankruptcy court, the district court held that the Sale Order did *not* exonerate Morgan from potential liability to Frederico and dismissed Morgan's adversary complaint.[13] Thus, despite the broad release language of the Sale Order, Frederico could continue to pursue her successor liability claims against Morgan in the New Jersey Action.[14]

The district court first rejected Morgan's preemption argument, i.e., that the New Jersey Supreme Court's holding in *Lefever*, that the product line theory of successor liability survives a bankruptcy court sale order, violated the constitutional supremacy of federal bankruptcy laws over state laws.[15] The district court observed that the constitutionality of the *Lefever* decision was not the subject of the appeal before it. Rather, the only issue at hand was whether enforcement of the Sale Order would be consistent with the Bankruptcy Code and due process.[16]

The district court then considered the underlying policy for permitting sales under Section 363 to be "free and clear" of "claims" that arise from the property being sold, not only "interests" in the property, as the text of the statute may suggest.[17] Echoing the bankruptcy court, the district court explained that the broad reading of "free and clear" to include tort claims serves to prevent tort claimants from directly suing purchasers and thereby jumping ahead of more senior creditors in violation of the Bankruptcy Code's priority framework.[18] A broad application of the "free and clear"

language also maximizes the value to the debtor's estate by limiting prospective purchasers' exposure to liability and thereby encouraging higher bids for the assets.[19]

After embracing this expansive reading of "free and clear," the district court was left to consider whether the Sale Order could extinguish Frederico's claims.[20] To determine whether a claim that first arose after the conclusion of the bankruptcy case, but as a result of a debtor's prepetition conduct (a "future claim"), can be extinguished by a Section 363 sale order, the district court first looked to precedent that analyzed whether future claims fall within the meaning of "claims" in other bankruptcy contexts.[21] Both the Fifth and Eleventh Circuits have considered and decided this issue, holding that the definition of "claim" cannot include the claims of unidentified future claimants.[22] Although the Second Circuit has yet to weigh in on this issue, it has previously observed the potential for practical issues, such as serving notice and "perhaps constitutional problems," that would result if future claims were treated as falling within the Bankruptcy Code definition of "claim."[23] Citing the long-recognized importance of notice and due process in the bankruptcy context, the district court observed that courts consistently hold that future claims cannot be discharged by bankruptcy court orders because it is not possible to provide notice to unidentified future claimants.[24]

The district court then applied this reasoning to a "free and clear" sale order under Section 363, noting that the same due process concerns apply regardless of whether the debtor sells its assets under Section 363 or confirms a plan of reorganization.[25] This is consistent with the rulings of other courts that have raised notice and due process concerns when considering successor liability in a Section 363 sale order context.[26] Specifically, the district court held that, because Frederico did not receive adequate notice in the bankruptcy case and therefore did not have an opportunity to participate in the case, enforcing the Sale Order to bar her right to seek redress in the New Jersey Action would deprive her of due process.[27] In so ruling, the district court made a policy pronouncement that the important policy of maximizing value to the estate does not outweigh the Bankruptcy Code's policy of affording claimants the opportunity to be heard and the constitutional right to due process.[28] The district court warned that an alterna-

tive approach, one that elevated maximizing value to the estate over the due process rights of future claimants and allowed the court to extinguish all future claims without notice, would make the assets of a debtor more valuable not only to creditors but also to managers and shareholders, and could entice companies to file for bankruptcy for reasons unrelated to the purposes of bankruptcy law.[29]

JURISDICTION

Bankruptcy jurisdiction extends to "all civil proceedings arising under [the Bankruptcy Code], or arising in or related to cases under [the Bankruptcy Code]."[30] Unlike the district court in *Morgan Olson LLC v. Frederico*, which assumed the bankruptcy court had jurisdiction to hear Frederico's motion to dismiss, the Seventh Circuit has considered a nearly identical lawsuit and dismissed on jurisdictional grounds. In *Zerand-Burnal Group, Inc. v. Cox*, Mr. Cox was injured years after the assets of the debtor, Cary Metal Products, Inc., were sold to Zerand-Burnal in a Section 363 sale.[31] The injury was caused by the debtor's prepetition conduct and Mr. Cox filed suit against Zerand-Burnal under Pennsylvania's successor liability law (the "Pennsylvania Action").[32] Like Morgan, Zerand-Burnal commenced an adversary proceeding in the bankruptcy court to enjoin the state law action based on the bankruptcy court order's approval of the sale "free and clear of any liens, claims or encumbrances of any sort or nature."[33] Upholding both the bankruptcy and district court rulings, the Seventh Circuit dismissed the adversary proceeding for lack of bankruptcy jurisdiction.[34] In concluding that the bankruptcy court had no jurisdiction over the Pennsylvania Action, the Seventh Circuit reasoned that it did not "arise under" the Bankruptcy Code because the Pennsylvania Action's relation to the bankruptcy case was too attenuated, with only a "distant federal origin" and an "extremely weak" federal interest given that the bankruptcy case had long concluded.[35] The Seventh Circuit also rejected the argument that the Pennsylvania Action was "related to" the bankruptcy, because it was not against the debtor, the debtor no longer existed, and all of the debtor's property had been distributed.[36]

In *Morgan*, the bankruptcy court rejected Frederico's jurisdictional

argument, which was based on *Zerand-Burnal*.[37] In line with other cases in the Second Circuit, the bankruptcy court held that it had subject matter jurisdiction to interpret and enforce the Sale Order and was not bound to follow the Seventh Circuit's restrictive interpretation of bankruptcy jurisdiction.[38] The district court did not question the bankruptcy court's assumption of jurisdiction.[39]

PRACTICAL CONSIDERATIONS

The district court's decision makes clear that prospective purchasers of assets from debtors in the Southern District of New York, whether purchased pursuant to a plan or a sale order under Section 363, must consider the potential for successor liability for future claims. The district court, although sympathetic to the concern that the uncertainty of future claims might have a chilling effect on the market for debtors' assets, essentially instructed potential purchasers to adjust their offers to take into account the risk of future claims.[40] Depending on the business of the target debtor, understanding these risks could well determine the success or failure of a purchase of assets under Section 363 or a reorganization plan.

NOTES

[1] *Morgan Olson LLC v. Frederico (In re Grumman Olson Industries, Inc.)*, 2012 WL 1038672 (S.D.N.Y. 2012).

[2] *See Epstein v. Official Committee of Unsecured Creditors of the Estate of Piper Aircraft Corp. (In re Piper Aircraft Corp.)*, 58 F.3d 1573 (11th Cir. 1995); *Lemelle v. Universal Mfg. Corp.*, 18 F.3d 1268 (5th Cir. 1994); *Western Auto Supply Co. v. Savage Arms, Inc. (In re Savage Industries, Inc.)*, 43 F.3d 714 (1st Cir. 1994).

[3] *Morgan Olson LLC v. Frederico*, 2012 WL 1038672 at *1.

[4] *Id.* at *2.

[5] *Id.*

[6] *Id.*

[7] *Lefever v. K.P. Hovnanian Enters., Inc.*, 160 N.J. 307, 310, 734 A.2d 290 (N.J. 1999).

[8] *See id.* at 316-18.
[9] *Morgan Olson LLC v. Frederico*, 2012 WL 1038672 at *2.
[10] 11 U.S.C. § 363(b).
[11] *See, e.g., In re Chrysler LLC*, 576 F.3d 108, 126 (2d Cir. 2009).
[12] 11 U.S.C. § 101(5)(A).
[13] *Morgan Olson LLC v. Frederico*, 2012 WL 1038672 at *14-15.
[14] *See id.* at 14.
[15] *See id.* at *4-5. U.S. Const. Art. VI, cl. 2 ("This Constitution, and the Laws of the United States…shall be the supreme law of the land; and the judges in every state shall be bound thereby, anything in the constitution or laws of any state to the contrary notwithstanding.").
[16] *Id.* at *5.
[17] *See id.* at 5.
[18] *See id.* at *6.
[19] *Id.*
[20] *Id.*
[21] *See id.* at *7-8.
[22] *See Epstein v. Official Committee of Unsecured Creditors of the Estate of Piper Aircraft Corp. (In re Piper Aircraft Corp.)*, 58 F.3d 1573, 1577 (11th Cir. 1995) ("The debtor's prepetition conduct gives rise to a claim to be administered in a case only if there is a relationship established before confirmation between an identifiable claimant or group of claimants and that prepetition conduct."); *Lemelle v. Universal Mfg. Corp.*, 18 F.3d 1268, 1277 (5th Cir. 1994) (holding that even the Bankruptcy Code's broad definition of "claim," cannot be interpreted to extend to claims of claimants who were completely unknown and unidentified at the time of the petition and "whose rights depended entirely on the fortuity of future occurrences").
[23] *See, e.g., In re Chateaugy Corp.*, 944 F.2d 997, 1003 (2d Cir. 1991).
[24] *See Morgan Olson LLC v. Frederico*, 2012 WL 1038672 at *9-10.
[25] *See id.* at *10.
[26] *See, e.g., Savage*, 43 F.3d at 722-23 (holding that parties to a Section 363 sale could not rely on the protection of the bankruptcy court to enjoin indemnification claim by retailer when they made no effort to provide notice to retailers, the debtor and transferee of the debtor's assets were aware that a certain product line was prone to personal injury claims, and the retailer's end-user customer was injured *before* the consummation of the asset sale); *Schwinn Cycling & Fitness Inc. v. Benonis*, 217 B.R. 790, 797 (N.D. Ill. 1997)

(holding that enforcing a Section 363 sale order to enjoin a future claimant's state law action would deny the claimant's due process rights and that the impossibility of providing notice to such unidentified future claimants did not lessen the due process implications).

[27] *See id.* at *11. The district court acknowledged that some bankruptcy cases, particularly those with debtors facing mass tort liability, have addressed the potential for future claims with a "future claim representative" who acts on behalf of the interests of future claimholders, such as negotiating a reserve fund to pay future claims as they arise. *See Morgan Olson LLC v. Frederico*, 2012 WL 1038672 at *12-13. The district court explicitly did not express a view on whether a future claims representative would have been appropriate in this case. *Id.* at *13.

[28] *See id.* at *13.

[29] *See id.* at *14 (citing *Zerand-Bernal Group, Inc. v. Cox*, 23 F.3d 159 (7th Cir. 1994) (Posner, J.)).

[30] 28 U.S.C. § 1334(b).

[31] 23 F.3d at160-61.

[32] *Id.* at 161.

[33] *Id.*

[34] *Id.* at 162-64.

[35] *See Zerand-Burnal*, 23 F.3d at 162.

[36] *See id.* In dicta, the Seventh Circuit acknowledged that Mr. Cox had not received notice prior to the sale, but observed that even if he had, Zerand-Burnal would still have had to defend against the claim in the Pennsylvania courts and could not obtain relief from the bankruptcy court. *See Zerand-Burnal*, 23 F.3d at 163. The court explained that had Mr. Cox received notice prior to the sale, he would not have a basis for a claim against Zerand-Burnal, not because the bankruptcy court could enjoin a successor liability action, but rather because the Pennsylvania successor liability remedy would not be available to him, given that he would have had a chance to obtain a legal remedy against the debtor itself. *See id.* Zerand-Burnal would have to bring that defense in the Pennsylvania court, not the bankruptcy court. *See id.*

[37] *See Morgan Olson LLC v. Frederico*, 445 B.R. 243, 248 (Bankr. S.D.N.Y. 2011).

[38] *See id.*; *see also In re Motors Liquidation Co.*, 428 B.R. 43, 57 (S.D.N.Y. 2010) (reasoning that the issuance of the sale order in question and its disputed provisions "arose under" the bankruptcy proceeding and were therefore not

"tenuous"); *In re Portrait Corp. of America, Inc.*, 406 B.R. 637, 641 (S.D.N.Y. 2009) (noting that case law in the Second Circuit gives Section 363 a broader reach than given in *Zerand-Burnal* and that it does not matter that the dispute is between two non-debtor parties).

[39] *See Morgan Olson LLC v. Frederico*, 2012 WL 1038672 at *3.

[40] *See id.* at *12.

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